Supreme Court, U.S.
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No. 89-1179

In The

Supreme Court of the United States

October Term, 1989

JEROME MIRZA & ASSOCIATES, LTD.,
an Illinois corporation,

Petitioner,

v.

UNITED STATES OF AMERICA,

Respondent.

REPLY BRIEF FOR PETITIONER IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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QUESTION PRESENTED

Whether an enrolled actuary's selection of actuarial assumptions and method for a defined benefit pension plan should be deferentially reviewed as a fiduciary decision under the Employee Retirement Income Security Act of 1974, 29 U.S.C. § 1001 *et seq.* ("ERISA").

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On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Seventh Circuit

REPLY BRIEF FOR PETITIONER IN SUPPORT

ARGUMENT

The assumptions and methods selected by enrolled actuaries determine the amount of the contributions by plan sponsors to defined benefit pension plans, and thus directly impact the security of pension payments promised to millions of plan participants. Congress specifically provided that the assumptions and methods were to be selected independently by each plan's enrolled actuary. The *de novo* standard of review applied to the actuary's selected assumptions and method by the courts below,

which does not give any deference to the assumptions and methods selected by the actuary, creates an inroad that will open the actuary's discretion to hindsight and second-guessing not only by the Internal Revenue Service ("Service"), but also by plan sponsors and plan participants and beneficiaries. Since actuarial assumptions and methods are, at the mandate of Congress, determined with the discretionary authority of the plan's enrolled actuary, the selected assumptions and methods should be reviewed with deference to the assumptions selected by the plan's enrolled actuary.

While claiming that this case presents "no issue of broad legal importance" (Brief, 6), the Government is apparently using this case as a springboard to conduct massive audits of small defined benefit pension plans, that is, plans with five or fewer participants. In November 1989, the Service advised its field agents of guidelines to be used in reviewing actuarial assumptions for small plans, including that interest rate assumptions of less than 8% and retirement ages of less than 65 must be challenged.[1] Supplemental Appendix ("S.App.") 1a. The Service revised its guidelines in January 1990,[2] and now requires field agents to obtain express approval from one

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[1] Although adopted in November 1989, the Service's memorandum of instructions was not released until February 1990. Petitioner understands that the memorandum was released after the American Society of Pension Actuaries filed suit under the Freedom of Information Act.

[2] The Service's January 19, 1990 Memorandum was released by the Service to the American Society of Pension Actuaries along with the November 1989 notice to field agents.

of the Service's four National Office actuaries before resolving an audit by allowing use of an interest rate assumption of less than 8% or a retirement age of less than 65. S.App. 2a-3a. The Service reportedly plans to examine about 20,000 defined benefit pension plans with five or fewer participants under its audit program. *Small Plan Audit Program Consistent With IRS Policy, Agency Official Says,* Daily Tax Report (BNA) No. 64, at G-1 (Apr. 3, 1990).

The Service's Assistant Commissioner for Employee Plans and Exempt Organizations cited the court of appeals opinion in this case as support for its extensive audits of small plans. The Government claims that it will raise $666 million in revenue from the audit effort. *Id.* The Service will likely have to strictly adhere to its dictate of interest rate assumptions of 8% and retirement age assumption of age 65 in order to achieve this revenue goal.[3] Thus, contrary to the Government's assertions, the question presented by the petition is of broad significance, and is involved in about 20,000 audits of small pension plans which the Service is now conducting.

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[3] The American Society of Pension Actuaries brought suit under the Freedom of Information Act on March 23, 1990 seeking to compel the Service to provide background information supporting the Government's estimates that the small plan audit program will raise a total of $666 million in fiscal year 1990 and 1991. The American Society of Pension Actuaries expects that the Service's standards of 8% interest and age 65 retirement will have to be strictly applied, with little flexibility to the facts of each case, to attain the Government's revenue goals. *Small Plan Audit Program Consistent With IRS Policy, Agency Official Says,* Daily Tax Report (BNA) No. 64, at G-1 (Apr. 3, 1990).

Petitioner does not maintain, as suggested by the Government, that the Service cannot review and question the assumptions selected by an enrolled actuary for a defined benefit plan. *See*, Government Brief, 7. Rather, petitioner maintains that in reviewing an actuary's assumptions and methods, which Congress provided were to "offer the actuary's best estimate of anticipated experience under the plan" (Code Section 412(c)(3), 26 U.S.C. Sec. 412(c)(3)), neither the Service nor the courts are free to substitute their judgment of reasonable assumptions and methods based on a *de novo* review. One of Congress' principal purposes in adopting ERISA was to assure that if a participant had been promised a defined pension benefit upon retirement, and if he has fulfilled whatever conditions are required to obtain a vested benefit, he actually will receive it.[4] Under both ERISA and the Code, all costs, liabilities, rates of interest and other factors used for funding purposes are to be determined on the basis of actuarial assumptions and methods which, in the aggregate, "offer the actuary's best estimate of anticipated experience under the plan."[5] ERISA Sec. 302(c)(3); Code

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[4] *Nachman Corp. v. Pension Benefit Security Corp.*, 446 U.S. 359, 375 (1980). Congress employed the statutory concept of "minimum funding standards" to assure that pension plans were adequately funded. ERISA Sec. 302, 29 U.S.C. Sec. 1083; Code Sec. 412, 26 U.S.C. Sec. 412.

[5] "Defined benefit pension costs generally are actuarial estimates of future costs of the plan", and Congress recognized that "[a]s a result, the assumptions and methods used by actuaries are basic to the application of minimum funding standards for defined benefit pension plans." S. Rep. No. 93-383, 93d Cong. 1st Sess. 68 (August 21, 1973). Congress

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Sec. 412(c)(3). Congress intended that the appropriate actuarial method and assumptions for a defined benefit pension plan would be "very much a matter of judgment" for the plan's enrolled actuary. H.R. Rep. No. 93-779, 93d Cong. 2d Sess. 94 (Feb. 5, 1974). Accordingly, an enrolled actuary's selected actuarial assumptions and method must be reviewed with deference. A court should review the investigation undertaken by the actuary in selecting the method and assumptions and, if the investigation was procedurally prudent, the court should not set aside actuarial assumptions and methods which were reasonably indicated by the results of the actuary's investigation.

The Conference Committee on ERISA noted that "a single set of actuarial assumptions will be required for all purposes". H.R. Rep. No. 93-1280, 93d Cong. 2d Sess. 285 (August 12, 1974). One of those purposes is the determination of the tax-deductible contribution necessary to adequately fund the plan.[6] Congress intended that the

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considered "establish[ing] the specific actuarial assumptions and methods that could be used by pension plans", but rejected that approach because "any attempt to specify actuarial assumptions and funding methods for pension plans would in effect place these plans in a straightjacket so far as estimating costs is concerned, and would be likely to result in cost estimates that are not responsible." H.R. Rep. No. 93-807, 93d Cong. 2d Sess. 27 (February 21, 1974).

[6] An employer is generally entitled to a deduction for a contribution paid to a tax-qualified plan in "an amount equal to the normal cost of the plan". Code Sec. 404(a)(1)(A)(iii), 26 U.S.C. Sec. 404(a)(1)(A)(iii). In determining the amount deductible under Code Sec. 404, the funding method and actuarial

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Service's review of actuarial methods and assumptions would be subject to ERISA's general rule of deference to fiduciary decision-making. While Congress expected the Service, on audit, to require a change of actuarial assumptions which are not "reasonable in the aggregate", Congress explained that "unless the assumptions used are substantially unreasonable, it is contemplated that generally the Service will not require a change of assumptions to be made effective for years prior to the year in which the audit is made." H.R. Rep. No. 93-807, 93d Cong. 2d Sess. 95 (February 21, 1974). Thus, even in an income tax context, Congress did not intend that an enrolled actuary's selected assumptions be set aside for a year prior to that in which an audit was made unless the assumptions were "substantially unreasonable". By providing that even the Service could not retroactively change the assumptions and methods selected by an enrolled actuary, Congress intended that even the Service would review historical assumptions with deference to the assumption selected by the plan's actuary.

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assumptions used are those used under Code Sec. 412. Code Sec. 404(a)(1)(A). Thus, the deductible "normal cost" of a defined benefit plan is determined using the single set of actuarial assumptions that are to be used for all plan purposes.

CONCLUSION

The petition for writ of certiorari should be granted.

Dated: May 2, 1990.

Respectfully submitted,

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NOV 29 1989

Assistant Regional Commissioners (Examination)
District Directors, Brooklyn and Cincinnati
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Actuarial Examinations of Small Plans

To ensure consistency in the actuarial examination of small plans, the following guidelines are to be followed when evaluating actuarial assumptions:

1) When reviewing interest assumptions, in addition to considering current investment rate of return, also consider that the plan can expect to earn a rate of at least equal to an investment in medium or long term government securities (which is at least 8 per cent).

2) If plan costs are based on a joint and survivor annuity, the post retirement interest rate should be 8 per cent.

3) Challenge all assumed retirement ages of less than 65 unless you know the individual has already retired or, in the extremely rare case, believe he will (not might) be retiring at that age.

Additional instructions will be provided at a later date for plans using unreasonable actuarial assumptions with the frozen initial liability method of funding.

If you have any questions, please call me, or if you prefer, members of your staff may contact Robert Froh at (FTS) 566-3310.

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JAN 19 1990

Assistant Regional Commissioners (Examination)
District Directors, Brooklyn and Cincinnati
Information Copy: EP/EO Division Chiefs

(signed) DONALD R. KEHOE

Acting Director, EP/EO Operations Division E:O
Director, EP Technical and Actuarial Division E:EP

Actuarial Examinations of Small Plans

This memorandum provides further guidance relative to the examination of small plan actuarial cases. Many inquiries have been received to clarify training aspects and guidance previously provided particularly, our memorandum issued November 29, 1989. When field personnel believe that facts and circumstances indicate a plan may use a pre-retirement or post-retirement interest rate of less than 8% or a retirement age less than 65, they must seek approval from one of the National Office actuaries (named below) prior to closing the case.

Please have available for discussion the assumptions used, proposed assumptions together with the facts and circumstances, and the case file to provide any other additional information that may be needed. (See IRM 7(10)(12)5.2 Unagreed Cases). As noted above, National Office actuaries have received many telephone inquiries from field personnel. We expect and we encourage field personnel to continue their telephone inquiries to National Office actuaries throughout the duration of this program. Also, it should be noted that as in all cases, where warranted, technical advice may be requested by field personnel.

If you have any questions, please call us, or if you prefer, members of your staff may contact Robert Froh at (FTS) 566-3310.

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